



SEC Speaks

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Audit Committee: Back to Basics

Agenda

- 1. *What is the role of the audit committee?***
- 2. *What are the responsibilities of the audit committee?***
- 3. *What are some key reminders related to the audit committee's:***
 - a. *Oversight of the auditor?***
 - b. *Assessment of auditor independence, including pre-approval of services?***
 - c. *Communications with the auditor?***
 - d. *Disclosures in the audit committee report?***



Back to Basics: Role of the Audit Committee

➤ *As the Commission has stated:*

“The audit committee, composed of members of the board of directors, plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system.”

➤ *Independent review and oversight of a company's:*

- financial reporting processes,
- internal controls and
- independent auditors.

▪ *Source: Release No. 33-8220 (Apr. 9, 2003).*



Back to Basics: Responsibilities of the Audit Committee

What are some of the SEC and exchange listing requirements for the audit committee?

- Appointment, compensation and oversight of the auditor by the audit committee
- Independence and qualifications of audit committee members
- Required communications with the auditor
- Reporting by the audit committee
- Content and disclosure of the audit committee charter



Back to Basics: Oversight of the Auditor

In fulfilling their responsibilities for overseeing the audit, what might audit committees want to consider?

- *Has there been a critical evaluation of the qualifications and performance of the auditor, or has the committee functioned as a “rubber stamp” for management’s recommendation?*
- *Has the audit committee had regular, direct contact with the auditor, or has management served as an intermediary?*
- *Has the audit committee functioned as an advocate for management?*
 - The audit committee chair sets the tone for the committee’s interactions with the auditor and with management



Back to Basics: Oversight of the Auditor

Who resolves disputes between management and the auditors?

- *The audit committee has responsibilities in resolving any disputes between management and the auditor (Rule 10A-3 and Sec. 10A(m)(2) of the Exchange Act)*
- *Remember that Section 10A(m)(5) gives the audit committee authority to hire independent counsel and other advisers to carry out its duties.*
- *By communicating with both management and the auditor, the audit committee may be able to resolve disagreements in the early stages.*



Back to Basics: Independence

What role does the audit committee play in auditor independence?

- *Independence is a critical part of auditor oversight and should be viewed as a shared responsibility between the company and its auditor.*
- *PCAOB Rule 3526 requires certain independence disclosures at the beginning of an engagement and at least annually.*
- *Monitoring independence is an ongoing responsibility and should include continuing dialogue between the auditor and the audit committee.*
- *Critical to understand the nature and scope of proposed services.*
 - *See the 21(a) report from January 2014 for importance of audit committee involvement.*



Back to Basics: Independence

Why is ongoing monitoring important?

- *Independence requires ongoing monitoring due to the changing nature of transactions and relationships.*
 - For example, business combinations by either the issuer or the auditor can affect the independence analysis significantly.
 - As another example, certain non-audit service arrangements can shift from their initial objectives (i.e., scope creep), which can have an impact on the independence analysis.
- *In addition to specific prohibitions, audit committees should be mindful of appearance issues when evaluating services or relationships with the auditor.*



Back to Basics: Pre-Approval Policies

What are some key considerations for pre-approval policies?

- Generally, all audit and non-audit services to be provided by the auditor require pre-approval (Section 10A(i) of the Exchange Act and Rule 2-01(c)(7)).
- Section 10A(i)(B) and Rule 2-01(c)(7)(C) provide an exception from the pre-approval requirement for certain “de minimis” services.
 - Note, however, that these de minimis services still need to be monitored for independence purposes.
- Consider whether procedures set forth in the pre-approval policy are designed to bring all services by the auditor to the attention of the audit committee.



Back to Basics: Pre-Approval Policies

What are some key considerations for pre-approval policies? (continued)

- *We encourage audit committees to have tailored policies that are detailed as to the particular services to be provided, as broad, categorical approvals would not meet the requirements.*
- *Audit committees should consider requesting detailed information about each engagement so that a well reasoned assessment can be made.*
- *Audit committees may consider pre-approving each engagement or certain types of engagements prior to commencement of the engagement.*
- *Review of policies on a regular basis can help ensure their continual effectiveness.*



Back to Basics: Fees

What role does the Audit Committee play with respect to audit and non-audit fees?

- *The audit committee's general oversight of the auditor includes oversight of fees.*
- *Item 9 of Schedule 14A requires the disclosure of audit, audit-related, tax and other fees in the proxy statement for the annual meeting.*
- *Audit committees should consider providing additional details about significant non-audit service engagements.*

The message here is that the “bottom line” should not drive the decision to retain and or hire an auditor. The decision should focus on which auditor is going to protect the interests of shareholders best.



Back to Basics: Required Communications

What are some of the required communications between the auditor and the audit committee?

- S-X Rule 2-07 communications regarding critical accounting policies, alternative treatment of financial information and other material written communications between the auditor and management;
- Communications required by PCAOB Auditing Standard No. 16;
- Discussions required by listing standards (e.g., the NYSE requires the audit committee to discuss inspections and reviews, which includes PCAOB inspection reports);
- PCAOB Rule 3526 independence disclosures.



Back to Basics: Required Communications

In fulfilling having these communications, what might audit committees want to consider?

- Consider timely communication throughout the year.
- The communication will be most effective when it is a two-way dialogue.
- Consider the required communications as a floor, not a ceiling.
- Audit committees are encouraged to engage the auditor on the topics raised. If there is other information needed, the audit committee should proactively seek it out.
- See also guidance in Section II.G. of S-X Rule 2-07 adopting release (Release No. 33-8183 (Jan. 28, 2003)).



Back to Basics: Audit Committee Report

What are the requirements of the annual public audit committee report?

- *Item 407(d) of Regulation S-K requires four items to be disclosed in the report above the names of the members of the audit committee:*
 - Whether the audit committee has reviewed and discussed the financial statements with management;
 - Whether the audit committee has discussed with the auditors those matters in the audit standard for audit committee communications;
 - Whether the audit committee has received and discussed certain matters regarding independence; and
 - Whether the audit committee recommended to the Board that the financial statements be included in the Form 10-K.



Back to Basics: Audit Committee Report

What might the audit committee want to consider about the Audit Committee Report and related disclosures?

- Item 407(d) requires additional information about the audit committee, but does not prescribe the location of those disclosures in relation to the names of the audit committee members.
- Audit committees are able to include additional disclosure that would be relevant to investors and may view this as an opportunity to explain the processes in place for overseeing the auditor.
- Audit committees are encouraged to consider what information shareholders would find useful to make an informed decision about ratifying the selection of the auditor.



Back to Basics: Takeaways

What are the key takeaways?

- *Audit committees are in a unique position to represent investors and play an important role in promoting high-quality, transparent financial reporting to investors.*
- *Monitoring independence is an ongoing responsibility of the audit committee.*
- *Frequent dialogue with management and a direct line of communication with the auditor are an important part of the oversight role*
- *Audit committees are encouraged to think critically about disclosures to investors about the committee's work.*